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Healthy Fundamentals or a Bubble?

> **"Every era of speculation brings forth a crop of theories designed to justify the speculation, and speculative slogans are easily seized upon. The term 'new era' was the slogan for the 1927-29 period. We were in a new era in which old economic laws were suspended."**
>
> **Economics and the Public Welfare**
> **Benjamin N. Anderson, 1949**

The above quote seems particularly appropriate to us in light of what we presently hear and read coming from Wall Street. Intoxicated by the seemingly relentless rise in the Dow, and the steady decline in bond yields, investors have been all too willing to celebrate the New Year by embracing the latest crackpot theories of eternal boom.

Certainly, there is no shortage of bullish stories. Some sound eerily familiar. The current obsession with the Internet, for example, calls to mind the passion for all things technological that marked the great bull market of the 1920s. Then, Radio was the miracle stock that would lead the market to ever-higher levels. Now, it's Netscape.

In this issue, we take a hard look at the current bull market, dissecting the real forces – as opposed to Wall Street's hallucinations – that have pushed stock and bond prices to such dizzying heights. Our central task, as we have explained in past letters, is to examine the sources of the flood of money that is financing the boom. Only in this way can we discover whether the markets rest on sound economic fundamentals, as conventional wisdom would have it, or are actually bubbles doomed to eventually burst.

The evidence, we think, is damning. The current boom is a bubble, perhaps the biggest ever. As in the late '20s, leveraged borrowing – not legitimate savings – fuels the speculative frenzy. Corporate mergers and stock buybacks pump billions into the market, while withdrawing billions worth of stock from circulation. The fact that these purchases come at the expense of productive, capacity-expanding investment is completely ignored.

In the eyes of the bulls, all this is justified by a U.S. economic miracle in the making. Thanks to new technology, and the rationalizing effects of the merger wave, America has escaped its rut of low productivity growth. Global competitiveness has been restored, even enhanced. Best of all: Thanks to the elimination of trade-union power, and the continuing erosion in real wages, the fruits of this productivity revolution are accruing almost entirely to profits. This secular trend in earnings will ensure market valuations remain reasonable, even as stock prices soar.

It's a pretty picture. Or at least it would be, if it were true. But the facts tell a different story. To be blunt: The productivity miracle is a mirage – America's technological achievements notwithstanding. The evidence can be found in revised GDP accounts that no longer statistically inflate the real value of U.S. economic output. The new figures show no meaningful acceleration in productivity growth from the bleak record of the 1970s and 1980s.

How, then, can we explain the undisputed surge in U.S. corporate profits? As we show, this is in part a byproduct of low interest rates and the weak dollar – which themselves stem from the Fed's easy money policies, the same policies that created the financial bubble. Low rates also have allowed American consumers to maintain their customary excessive borrowing and spending in the face of stagnant or declining incomes.

By their nature, these are unsustainable sources of profit growth. Ultimately, sky-high consumer debt levels and faltering profits will sap the life from an economic expansion that already appears extremely anemic. Further Fed easing can postpone, but cannot prevent, the bubble's day of reckoning.

SLOWDOWNS ALL AROUND

Looking back at 1995, we can certainly say it was a disappointing year for the world's major industrial economies. A year ago, growth forecasts generally were being revised upward – to the point where fears of inflationary overheating even emerged in the United States.

Instead, economic growth everywhere has abruptly slowed. It's revealing to compare the OECD's December 1994 forecasts for growth in 1995 with current estimates. Obviously, actual economic growth has badly lagged the forecasts in most countries. The worst cases have been Japan, Canada and Mexico. Even worse, in a number of countries these annual figures mask a sharp slowdown in the latter part of the year. In Europe, some economies already are stagnating. But by far the biggest disappointment has been in Japan, where it was widely taken for granted that massive monetary and fiscal stimuli could not fail to work.

OECD Growth Forecasts for 1995

	Dec. 1994	Dec. 1995
U.S.	3.1%	3.3%
Japan	2.5%	0.3%
Germany	2.8%	2.1%
France	3.1%	2.7%
Italy	2.7%	3.1%
Britain	3.4%	2.7%
Canada	4.2%	2.4%
Mexico	4.0%	-6.0%

Source: OECD

Turning to currency markets, the biggest disappointment for consensus opinion once again has been the U.S. dollar. Given the widespread expectations of strong economic growth in the United States in 1995, compared to declining interest rates in Germany and drastic reflation in Japan, a rising dollar appeared to most currency experts a foregone conclusion as 1994 ended. Instead, massive dollar purchases by the world's major central banks – and by the Bank of Japan in particular – were required to head off a total dollar collapse.

Was 1995 a great year for financial investors? For bond investors, certainly yes, though to differing degrees depending on the currencies in question. But for global stock investors, it was a very mixed year, with Wall Street's outstanding performance matched to disappointing results in Europe and Japan, and severe losses in many of the emerging markets.

AMERICAN EUPHORIA, EUROPEAN GLOOM

Reading numerous economic reports from and about the different countries and regions, one thing strikes us above all else: the glaring difference in the tenor of remarks about the economic outlook for the United States and Europe. Quite a few reports we read from brokers rave about the U.S. economy's improving fundamentals – not least of which is an alleged policy consensus in favor of price stability and fiscal balance. This is said to promise a combination of steady, solid economic growth, high capacity utilization and low inflation.

It all amounts to a paean of praise for the Greenspan Federal Reserve. Though the term "new era," is studiously avoided (owing to the bad memories associated with it), that's clearly what is meant.

Europe completely lacks such propagandists. It, too, is enjoying new lows in inflation, even in countries that have experienced drastic currency depreciation, such as Britain. In some countries, like Germany, low inflation is taken for granted in any case. But nobody really attributes this disinflationary trend to monetary and fiscal policies that are more stability-oriented than in the past.

To most Europeans, lower inflation rates are rather the inevitable result of notoriously *bad* governmental policies, past and present, that have ravaged long-term economic growth, leading to permanently high and rising unemployment. For good reasons, the stock markets of Europe see no reason to celebrate this.

Global Capital Market Trends

Equities
Selected Markets, % Change

Country (December 29)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	2.0%	14.0%	14.0%	-1.0%	20.8%
Canada	0.9%	12.2%	12.2%	-0.7%	18.1%
France	0.8%	-1.2%	-1.2%	-7.2%	8.7%
Germany	0.4%	8.5%	8.5%	-2.7%	17.9%
Hong Kong	4.7%	22.9%	22.9%	0.0%	44.6%
Japan	7.2%	0.6%	0.6%	-0.7%	37.2%
Mexico	2.0%	15.3%	15.3%	-2.0%	91.9%
Spain	3.6%	19.6%	19.6%	2.5%	13.8%
U.K.	0.9%	20.4%	20.4%	0.0%	24.9%
U.S.	1.4%	33.6%	33.6%	-0.9%	34.2%

Ten-Year Bond Yields
Selected Markets, Basis Point Change

Country (December 29)	Current Rate(%)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	8.27	4	-177	-177	-230	19
Canada	7.08	-16	-206	-206	-260	0
France	6.63	-31	-164	-164	-176	0
Germany	6.03	-19	-159	-159	-172	1
Japan	3.07	19	-150	-150	-165	47
Spain	9.70	-56	-213	-214	-286	0
U.K.	7.42	-17	-130	-130	-139	6
U.S.	5.57	-26	-225	-225	-230	0

Exchange Rates
Versus U.S. Dollar, % Change

Country (December 29)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia ($)	1.35	-0.7%	-4.3%	-4.3%	-4.4%	4.6%
Canada ($)	1.36	-0.5%	2.5%	2.7%	-2.6%	4.2%
France (*f*)	4.91	0.7%	8.0%	8.0%	-3.2%	9.0%
Germany (DM)	1.44	0.1%	7.2%	7.2%	-6.2%	8.1%
Japan (¥)	103.51	-1.8%	-3.9%	-3.9%	-28.4%	1.0%
Spain (Pt)	121.67	0.7%	7.5%	7.5%	-2.9%	9.3%
U.K. (£)	1.55	1.0%	-1.0%	-1.3%	-5.5%	1.0%

To be sure, the U.S. economy in the past three or four years has performed rather better than the European economies, after having underperformed in prior years. With its growing population and labor force, the United States needs stronger growth than Europe, where both are stagnating. Still, the current cyclical U.S. upswing stands out as by far the most anemic in the whole postwar period. Average annual real GDP growth of a mere 2.5% over the first four years of this cycle compares miserably with 5% average growth in the previous postwar cycles.

BORROWING THE GOOD LIFE

In terms of employment gains, the United States clearly is the best-looking industrialized economy, putting all of its rivals to shame. But in terms of real wage rates, it is by far the worst-looking.

Since the mid-1970s, real hourly wages have fallen in every major sector of the economy. At the same time, many high-paying jobs in manufacturing have disappeared, while low-paying service jobs have mushroomed. Despite increasing job participation by married woman, real median family income has been flat for two decades.

Desperate to maintain their living standards despite income weakness, middle-class Americans have purchased the good life by racking up debt and slashing savings. In 1994, every dollar added to U.S. consumer incomes was matched by $1.07 added to consumer debt. In other words, more than half of consumers' additional spending power came from borrowing. Income growth of $326.5 billion was matched by debt growth of $351.6 billion. Is this trend sustainable? Definitely not.

According to Wall Street, the U.S. economy is enjoying a virtual renaissance, reflecting not only rigorous cost-cutting but also an investment boom that is delivering, and will continue to deliver, rapid productivity gains.

It almost looked like a credible story, until the Commerce Department's Bureau of Economic Analysis recently published revised national income and product accounts going to back to the 1960s, using the new chain-weighted measure of GDP. This new measurement eliminates much of the distortion caused by using a fixed benchmark year – most recently 1987 – to calculate constant dollar prices.

Leaving aside the particular reasons for this change in statistical methodology, the main, spectacular effect has been to substantially reduce the weight of computers and computer equipment in the GDP output

figures. More importantly, this revision causes the whole mirage of accelerated productivity growth to disappear into thin air. Sharply lower productivity growth directly implies higher unit labor cost inflation. Measured by the new chain-weighted accounts, unit labor cost inflation currently is running at an annual rate of 2.2%, rather than the 0.4% calculated under the previous GDP measure.

How, then, are we to explain the strong rise in U.S. corporate profits in the 1990s, given this new, dismal productivity picture? We see four primary factors at work:

Effect of U.S. GDP Revisions On Productivity Growth

Average Annual Gains

Period	Old Data	Revised Data
1960-73	2.5%	3.0%
1972-79	0.6%	1.0%
1979-90	0.8%	0.9%
1990-94	1.9%	1.3%
1990-91	1.3%	1.2%
1990-92	2.8%	2.6%
1992-93	1.3%	0.5%
1993-94	2.2%	1.0%

Source: Bureau of Labor Statistics

- Increased leverage of the financial structure of firms, through the substitution of debt for equity – creating a shrinking equity basis.
- Given their high and soaring debt levels, U.S. corporations have benefited immensely from the steep, secular decline in U.S. interest rates.
- Dollar depreciation, which has improved international competitiveness and resulted in currency gains from investments in countries with currencies that have appreciated against the dollar.
- Cheap labor has promoted a production structure that is labor-intensive as opposed to capital-intensive. This declining use of capital has resulted in higher capital productivity, or to put it another way, in a higher rate of profitability per unit of capital.

This last phenomenon – substituting cheap labor for capital – is well known in European economics. A declining price of labor leads to more labor-intensive output. But in Europe, the opposite trend predominates. The high and rising price of labor drives businesses out of labor-intensive production, leading to chronic unemployment.

In general, there is great admiration for the U.S. solution of falling wages and rising employment. America's jobs machine is the envy of Europe. It is hailed as a great achievement, associated partly with the U.S. advance in technology and partly with the flexibility and mobility of U.S. labor, as compared to technological stagnation and extremely rigid labor markets in Europe. But this achievement has been bought at great cost – as U.S. workers know all to well.

The truth of the matter, we would say, is that both falling wages and rising unemployment are social evils, brought on by years of overconsumption and underinvestment, and the consequent shortage of capital. But we are not so quick to praise the former evil over the latter. For it has to be conceded that the European disease – high unemployment – effects far fewer people.

HOW SUPERIOR IS THE U.S. ECONOMY?

To many people, the outstanding performance of U.S. equities in 1995 had perfectly good reasons. We note the widespread view that the fundamentals of the U.S. corporate sector are far superior to those in most other countries. Thanks to years of rigorous cost cutting, it supposedly is leaner and fitter than in any other

economy in the world. It evidently is superior in job creation. U.S. corporations are tops both in inventing and applying modern technology.

Best of all, the current economic recovery has been powered by corporate investment to a degree unprecedented in decades. It seems only natural that this extraordinary economy should also produce extraordinary business profits, in turn justifying an extraordinary boom in share prices.

Who is not impressed by these arguments? No doubt, there is more than a kernel of truth to all of them. Numerous U.S. corporations are highly competitive. America's technology sector is unique in the world. To this technological lead, we can add the endless dollar depreciation, the lowest rate of wage increases among the industrialized countries, the years of cost cutting, and the unique mobility and flexibility of America's labor force. Put these together, and it really does look like a marvel of an economy. Still, this can't be whole truth, if only for three obvious reasons.

THREE FLIES IN THE OINTMENT

The first conspicuous flaw in the bull story is the yawning U.S. trade gap. With all of its competitive advantages, one would expect U.S. manufacturing to be flooding the world with the goods it produces. But exactly the opposite is happening. Foreign producers are flooding the U.S. market. The U.S. merchandise trade deficit, currently running at an annual rate of about $180 billion, now equals roughly 15% of domestic manufacturing production.

The second conspicuous flaw in this picture of U.S. competitive superiority is the dismal productivity trend referred to earlier, and the inherent proliferation of low-wage employment. This downtrend in wages and living standards is mainly taking place through a secular shift in employment away from higher-paying manufacturing jobs and toward lower-paying service jobs. Since 1985, the former have declined by about one million, while the latter are up by some 20 million.

The third major flaw in the bullish scenario is the persistent, massive imbalance between consumer incomes and consumer spending. It is customary to hail the mobility and flexibility of the U.S. labor force in adjusting their wage demands to lower-paying jobs. However, there has been no corresponding adjustment on the spending side. To maintain their living standards despite declining earnings, consumers have been going into hock as never before, spending persistently in excess of output and income growth.

As a share of GDP, U.S. private consumption has soared from an average of 62.6% during 1970-80 to a recent peak of 67.7%. Save for Greece, this is the highest ratio among the industrialized countries. The counterpart of this chronic overconsumption has been a shortage of productivity capacity and the mushrooming trade deficit.

The complete failure to raise labor productivity is the U.S. economy's crucial deficiency. Being the one and only key to an improved standard of living, productivity really is the most crucial variable. In Germany, the productivity of the overall economy has been rising at an average annual rate of 2.5%, twice as fast as in the United States.

It is undisputed that the new chain-weighted GDP calculations provide a sounder measure of output and productivity. Nevertheless, there is a widespread sense of disbelief that U.S. productivity growth is still stagnating, despite rapid technological innovation, restructuring, improved business management, deregulation, etc. Quite a few seek consolation in the conjecture that technological progress simply is too difficult to measure. How, for example, does one measure the increased efficiency of a new type of fax machine, or a new computer operating system?

In short, it's the wrong question. The productivity of machinery varies considerably, depending on changes in the intensity of its use. At issue is not the productivity of the machine but rather that of the labor required to

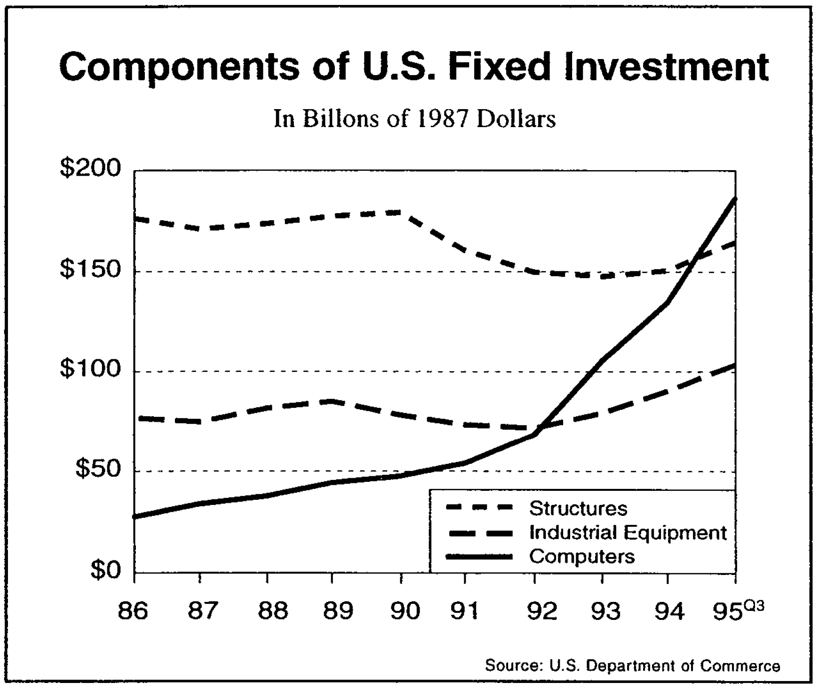
operate it. And the measurement of labor productivity poses no problems even for beginners in mathematics. One simply relates working hours to real GDP growth. Therefore, it isn't possible to explain away the new, disastrous productivity figures simply by casting doubt on the statistics.

THE PRODUCTIVITY DEBACLE IS FOR REAL

In our view, the failure of the new technology to raise productivity is not so difficult to understand. Too much of it serves to provide information, and not enough to foster production. The Internet may be a technological miracle, but most of the information that it distributes does not add to GDP, for the good reason that it does not add to income. Increasingly, technology is bypassing GDP.

Similar caveats apply to the whole investment boom in the United States during the past few years. Of the overall rise in business spending on producers' durable equipment between 1990-95, no less than 61% was spent on computers and information processing equipment, just 7% was spent on industrial equipment – in other words, on production machinery. Investments in structures actually fell sharply until early 1993 and since then have only partly recovered.

The chart shown here strikingly illustrates two drastic changes in the investment patterns and preferences of U.S. corporations. One is a shift away from assets with long lives (structures) toward assets with short lives (equipment). The other one is a shift away from production equipment to information and cost-cutting equipment.



These trends started in 1980s, but they have sharply accelerated in recent years. Generally speaking, most of this investment spending is designed primarily to raise corporate profits by saving labor, and does little or nothing to raise productive capacity.

From the point of view of future economic growth, the worst component of investment spending is of course the takeover-merger mania. Hundreds of billions of dollars have been used to inflate stock prices without adding anything to the real capital stock of corporate America.

THE YEAR OF WALL STREET

If 1995 was a disappointment for most of the world's economies, and for the dollar, nevertheless it clearly was the year of Wall Street. Whether bonds or stocks, Wall Street fared best. American shares rose on the year by 35%, to a total market capitalization of more than $6.2 trillion, or 93% of GDP. True, in dollar terms Zurich managed a gain of 40%, but this owed mainly to substantial currency gains.

Ironically, stock investors outside the United States completely missed out on Wall Street's bull run. During the first half of 1995, foreigners were net sellers of U.S. stocks – even as they were heavy net buyers of U.S. bonds.

And which stock exchanges fared the worst? Oddly, the emerging markets did. Many of them registered double-digit declines, even though a year ago they were the declared favorites of many European and American institutional investors. These markets ended the year with an average 11% decline. European stocks were up an average 8%.

The big underlying story has been the tumble in bond yields, fully reversing the damaging increases seen in 1994. At first sight, it looks like a repeat of the bull market in bonds two years ago. But its impact on global stock markets has been radically different. In 1993, with the federal funds rate slashed to 3%, U.S. stocks turned in a pretty dull performance, gaining just 7% on the year, while the world index, not including the United States, climbed 30%. During 1995, by contrast, with federal funds ranging between 5.5% and 6%, U.S. stocks have been ablaze, as opposed to sluggish or sliding markets abroad.

Frankly speaking, we are at a loss to make sense of these movements, except as rather random waves of speculation. Even on Wall Street, though, 1995 was not all sunshine and roses. Picking the wrong stocks – or picking them at the wrong time – could have cost investors a considerable amount of money. While Microsoft, the bellwether of the U.S. computer stocks, hit a peak of 109¼ in July, it ended the year at 87¾, off nearly 20% from that high. Walmart, the giant American retailer, closed out 1995 at 22¼, 19% below its high for the year.

How to explain this immense difference in stock market performance between Wall Street and the rest of the world? Is it that economic and monetary conditions in the United States were so much better than elsewhere? Certainly not. Among the major industrial countries it was, more or less, very much the same picture: slower economic growth, lower inflation, rising profits, modest monetary easing. To be sure, there were some marginal differences – slower growth in Europe and Japan, higher short-term rates in the United States – but nothing that would reasonably explain the wide differences in stock performance.

Still, we think it is important to find out what precisely caused these divergences. Is the boom on Wall Street underpinned by sound foundations? Or is it a bubble that foreshadows its own bursting?

In general, current discussion about the health of Wall Street's bull run centers on the single question of valuation, as measured by three conventional yardsticks: dividend yields, price-to-earnings ratios, and price-to-book value ratios. While dividend yields are at record lows, and price-to-book ratios are at record highs, the bulls take enormous comfort in the average price-to-earnings ratio, now hovering around 17 for the S&P 500, down from a peak of 26 in mid-1992.

In our view, this approach is fundamentally flawed because it completely fails to take into account the chief vehicle behind every boom: the flow of funds entering the market and its sources.

Every bull market is liquidity driven. That's a truism. The critical question is what are the sources of the liquidity that is flooding the markets? But precisely this question is never asked and never discussed. Truly it has been said: It's extremely difficult to recognize a bubble when you are inside one.

As we have stressed in the past, the salient distinction is between money that flows from current savings and money that stems from inflationary and speculative sources – such as bond purchases by central banks and commercial banks, financial leveraging, and withdrawals from existing money balances. These are the flows that make a bubble.

WALL STREET'S OTHER GREAT YEAR: 1929

With the benefit of hindsight, it's easy to see that the stock market boom of the late 1920s unambiguously was a bubble heading for a spectacular crash. But this was not detectable at the time by the trend in

valuations. The well-known economist Irving Fisher even commented on this puzzling anomaly in his 1930 book, *The Stock Market Crash – and After*.

Between January and the end of September 1929, the price-earnings ratio for the All Industrials Index (a forerunner of the modern-day S&P Industrials Index) *fell* from 16.2 to 13.5 – not too far from the traditional 10-to-1 ratio then considered fair valuation. While stock prices climbed over the year, earnings climbed even faster. "It is important to note that during 1929, as compared with 1928, the price-earnings ratio fell not only on the average, but for a majority of the individual stocks listed (in the index)," Fisher wrote. In light of profits, then, the stock market boom seemed perfectly justified. Moreover, the U.S. Treasury enjoyed a surplus at that time. Long-term government bonds yielded around 3.6%.

In terms of valuation, the U.S. stock market thus went in the course of 1929 from strength to strength. What actually portended and predicted the coming disaster was massive, reckless financial leveraging. This was done through two main vehicles: proliferating investment trusts operating with borrowed money; and soaring margin loans financed by banks and brokers. Credit, margin and leverage were the key words of the 1929 stock market boom.

Needless to say, the bulls of 1929 – like their modern counterparts – had their eyes glued on improving profits and stock valuations. Not a thought was given to the fact that the rising tide of money deluging the stock market came from financial leverage and not from savings.

In retrospect, it is undisputed that brokers' margin loans to customers played a key role both in fueling the boom and in driving the subsequent crash. During 1927-29, these loans skyrocketed 183%, from about $3 billion to $8.5 billion at the end of September 1929. Putting it into perspective, this equaled almost 10% of GDP, or about 25% of outstanding bank credit.

While margin loans for stock speculation exploded, there was at the same time a drastic shift in the financing of these broker loans away from banks to corporations. This led to great confusion. By reducing bank credit and bank money growth, this shift in financing created the false impression of monetary tightening. But credit, in particular credit for speculation, was abundantly extended right up until the crash. Only it was created outside the banking system, leaving the money supply unchanged.

Today it is often argued that a market crash is not possible in the absence of a major monetary squeeze. It is true that the Fed raised its discount rate from 5% to 6% on August 9, 1929, eleven weeks before Black Monday. This is often cited as the fatal tightening that precipitated the crash. But the truth is rather different.

Faced at the time with an overheated stock market and a weakening economy, the Fed tried to compromise. The hike in the discount rate was intended strictly as a symbolic warning to stock speculators. The really important move, which ironically had a strongly positive effect on the markets, was a simultaneous *cut* in the Fed's buying rate for prime bankers' acceptances – the key open-market rate at the time – from 5.25% to 5.125%.

Against the backdrop of rising Fed purchases of acceptances, the call loan rate for broker loans dropped and dropped sharply, from 9.6% in August to 6.2% on October 12. As the crash gathered steam, the rate fell further, to just 4%. This hardly constituted a major monetary squeeze.

WHAT MAKES A BOOM? NOTHING BUT BUYING!

We thought it was time to debunk some of the major fallacies in the conventional perception of what happened during the boom and crash of 1929. The chief lesson of all is to recognize the necessity of distinguishing between the rhapsodizing of the experts, which is used to justify the boom, and the reality of the actual flows of funds and their sources. During the 1920s, there was much talk of a new era in stock prices,

created by price stability, high productivity gains and eternally rising profits. But what truly drove stock prices skyward was the flood of money procured through massive leveraging. It was a speculative bubble.

Every extraordinary boom brings forth a crop of apparent rationalizations designed to justify speculation. To such "theories," our stereotypical response is to check the sources of the money driving the speculative surge. How much comes from savings proper, and how much from central banks, commercial banks and financial leveraging?

A favorite explanation of the prolonged U.S. stock market boom of the 1990s has been the stampede of private investors into mutual funds. This is billed as a healthy, sustainable portfolio shift away from barren cash and into productive investment. And the trend, the bulls argue, still has a long way to run.

But as our October letter (*The Great Dollar Hoax Exposed*, page 7) already has disclosed, the whole story is utter nonsense. The truth is that individual inflows into the stock market through mutual funds have been more than offset by private direct sales of stocks. What truly is stoking the Wall Street boom in stocks is merger mania, combined with a host of other corporate stock purchase programs.

We read with great interest a recent article in *Barron's* (December 4, 1995) making the same point, but citing even bigger numbers. Ours came from the Federal Reserve, while *Barron's* drew on calculations from Morgan Stanley. In any case, according to these estimates, merger volume totaled about $439 billion in 1995, of which about 44%, or $193 billion, involved cash payments. Further takeovers, done for a combination of cash and stock, included a cash portion of about $30 billion. In addition, U.S. corporations bought back about $24 billion of their own shares. Together, these operations reduced the supply of stock outstanding by a staggering $250 billion. As new issues amounted to about $75 billion, the net reduction was $175 billion.

Assessing the effects of these huge corporate stock purchases on the market, it must be realized that they have a twofold leverage effect. While putting hundreds of billions of dollars into investors' pockets, they at the same time take a like amount of shares out of the market. Institutional investors, in particular, are virtually compelled to pump the cash they receive promptly back into the market, pushing share prices still higher.

Altogether, the above figures make crystal clear how bogus the conventional bull stories are about better U.S. corporate fundamentals. Most of the money that has been poured into the stock market has had nothing to do with such reasons. It has been coming from the corporations themselves in the pursuit of takeovers and mergers at the expense of capacity-raising new investment. Most obviously, this is asset inflation driven by unlimited credit.

Just the same vast discrepancy between bullish fairy tales and facts prevails in the U.S. bond market. The fairy tale says that bond yields are heading downward due to a healthy decline in inflation rates. But in reality, the big buying that has driven bond yields lower has come from foreign central banks and heavily leveraged yield-curve playing speculators.

Holdings of U.S. Treasury bonds by foreign central banks in Fed custody jumped in 1995 by a record-breaking $89 billion, financing more than *half* of the U.S. budget deficit. The other big source of bond purchases, defying any measurement, is an orgy of yield-curve playing between Tokyo and New York. American bond speculators have been borrowing at the short end of the Japanese yield curve and using the funds to buy short-term U.S. bonds. With little or no interest-rate risk, they can earn a truly huge carry – currently about 500 basis points.

Underlying this highly leveraged play have been two crucial assumptions: that the desolate state of the Japanese economy will compel the Bank of Japan to keep money very loose, and that the bank will spend whatever it takes to prevent any rise in the yen against the dollar. The Bank of Japan is the real guardian angel behind this speculation, which so far has allowed the American bond bubble to postpone its rendezvous with reality.

THE JAPANESE CONUNDRUM

In anticipation of the big reflationary effort by the Bank of Japan, Japanese banks stocks have skyrocketed from their 1995 lows by 30-40% and more. Notably, the stampede into Japanese equities – and bank stocks in particular – has been led by foreign buying, amounting in the third quarter of 1995 to net purchases of $27.4 billion. But heavy stock sales by Japanese institutions and investors, who have remained stubbornly bearish on their economy and markets, have put something of a brake on the bull run.

Who is right – the bearish Japanese or the bullish foreigners? For the time being, we side unreservedly with the Japanese, not simply because we think they ought to know their own markets best, but also because the story of effective central-bank reflation in Japan clearly is not borne out by the monetary facts.

What we observe are quite considerable month-to-month fluctuations in the relevant aggregates, but nothing that deserves to be called a meaningful uptrend, let alone an explosion, in central-bank credit. Thus, we fully maintain our previous verdict that the Bank of Japan is, to use the common phrase, "pushing on a string."

Looking at the bank's balance sheet, we see in the first place a plain contradiction to the consensus view, which chooses to see the most aggressive money pumping. Between April and October, the Bank of Japan actually slashed its holdings of government bonds from ¥38.1 trillion to ¥31.9 trillion. We presume those bond sales were necessary to sterilize the bank's simultaneous heavy dollar purchases, which otherwise would have caused the call money rate – currently at a rock-bottom 0.4-0.5% – to collapse all the way to zero.

In terms of bank reserves, interest rates and the yield curve, Japanese monetary policy appears exceedingly loose. However, as we repeatedly have stressed, the normal money multiplier isn't working because the banks are not lending. While broad money growth (M2+CDs) has accelerated to a respectable 3.2%, this has been offset by weak credit growth and falling velocity of money circulation. The table below gives a comprehensive picture of the persistent monetary deadlock in Japan. However cheap credit becomes, it remains extremely scarce.

Increase in Japan's Money Supply, and its Sources

Percentage Change

	1990	1991	1992	1993	1994	1995H1
Money Supply	7.4%	2.3%	-0.2%	2.2%	2.8%	3.2%
Domestic Bank Credit	10.9%	3.5%	3.5%	3.0%	0.4%	1.5%
Claims on public sector						
Treasury accounts	1.5%	-2.1%	0.8%	1.7%	-1.2%	-0.1%
Local accounts	0.0%	0.0%	0.2%	0.5%	0.5%	0.6%
Claims on private sector	9.4%	5.5%	2.5%	0.9%	0.3%	0.9%
Loans	8.0%	4.8%	2.2%	0.6%	-0.3%	0.2%
Bonds and stocks	1.4%	0.7%	0.3%	0.3%	0.7%	0.7%
Foreign liabilities	1.0%	-2.5%	-2.0%	-1.3%	-0.8%	-0.5%
Non-monetary liabilities	2.5%	3.7%	5.7%	2.1%	-2.4%	-1.3%

Source OECD

We wouldn't say there is anything in the table that supports the notion of a nascent credit explosion in the making. During the third quarter, for which figures now also are available, the picture didn't materially change. Banks added modestly to their loans and sold government bonds. The fact that the money supply grew faster than bank credit reflected mainly a shift in bank funding away from debentures and Euro-borrowing to domestic deposits.

Speaking of reflation in Japan, a comparison with monetary developments in the United States is eye-opening. Over the 12 months ending in October, U.S. bank credit expanded by 8.1%, or $268 billion. Yet the U.S. commercial banks added a mere $116 billion to the broad money aggregates, funding their credit expansion largely by instruments other than deposits. Taking lending outside the banking system into account, U.S. nonfinancial debt growth during this period totaled $688 billion, vastly in excess of money or liquidity growth.

Nevertheless, it is true Japanese money has been pouring into U.S. bonds and stocks. But it has passed through a channel very different from what was expected and predicted on Wall Street. The markets have been expecting heavy buying by yield-hungry Japanese institutional investors faced with abysmal returns on medium and long-term yen bonds. What actually has happened is the novel form of global yield-curve playing we cited earlier.

SORRY, WE SEE THE SITUATION WORSENING

There is a widespread view that the massive monetary and fiscal policy measures taken by the Japanese in 1995 will, at long last, revive the economy. Well, given the enormity of the recent fiscal packages, they must have at least some expansive effect. But the truly crucial question is whether or not fiscal and monetary finally will succeed in activating a self-sustaining recovery sufficient to boost Japanese GDP and incomes.

In this respect, we read mostly positive assessments from the major brokerage firms. The main argument is that the BoJ finally has become highly accommodative, fostering a sharp depreciation of the yen and promising heavy monetization of the budget deficit through outright purchases of government bonds. Together, these trends are supposed to stop the crowding out of private investment that a rise in bond yields tends to cause.

While yen depreciation is of course helpful, the rest of the story is bunk. It begins with the alleged partial monetization of the budget deficit. As we explained earlier, the Bank of Japan's balance sheet shows precisely the opposite. To repeat: Since April, the bank has been a heavy seller, not a buyer, of Japanese government bonds.

The undisputed precondition for a sustained revival of Japan's economy is consolidation of the financial system. But its difficulties are proving to be far more serious than previously thought. Real estate prices continue to decline, adding steadily to nonperforming loans.

In March of this year, the major banks reported ¥12.5 trillion in such loans. In September, they reported an increase to ¥13 trillion – despite having written off nearly ¥5 trillion in the interim. It seems there is a race on between rising bad loans and loan write offs. The banks appear to be losing.

Nor are we great believers in the benign growth effects of reckless deficit spending. In the aggregate, the six Japanese fiscal packages implemented since 1992 amount to nearly 14% of Japan's GDP. That compares with cumulative real GDP growth during the period of little more than 1%. Since 1991, general government debt has soared from 70% to 95% of GDP. Soon enough, Japan may have a fiscal crisis on top of its banking crisis.

CONCLUSIONS

Earlier we asked: What makes a boom? And we answered: "Nothing but buying!" But the key issue really is to know the sources of the money flowing into the markets. Looking at the U.S. economy and Wall Street, we don't see superior economic fundamentals, but rather superior opportunities for geared speculation. That's why U.S. interest rates, short and long, have had greater scope to fall. Moreover, we think that the Fed, more than any other central bank, operates its monetary policy so as to support the financial markets.

In short, the Wall Street boom is a huge speculative bubble. But the slowing economy, evoking further Fed cuts, is bound to add fuel to this speculation. In the same vein, it has to be assumed the bullish influence of cash deals will continue, as long as everybody feels confident the economic slowdown will not degenerate into a recession.

Soft or hard landing in 1996? That's really the central question. Both in Europe and in the United States, the economic surprises in the fourth quarter all have been on the downside. But given the global monetary easing and the sharp declines in long-term interest rates, conventional wisdom holds there is little need to worry about a hard landing of any economy, least of all the United States.

In our view, there is far too much complacency about the underlying health and strength of the industrialized economies, especially the U.S. economy. The bulk of the improvement in profits has been the by-product of various temporary influences and an extraordinary compression of wages. The truth is that the U.S. economy has not broken out of its snail-like productivity growth. Superior economic growth and financial bullishness have been made possible by rampant credit expansion and financial leveraging.

That the recent economic recovery in the United States and Europe has been the most feeble in the whole postwar period is conveniently ignored. Instead, this fact is glorified as heralding a new era of low and falling inflation – an El Dorado for bond and stock speculation.

At the same time, there is growing gloom about the continental European economies. They are widely perceived as trapped by inflexible labor markets, high wage costs, powerful unions, a lack of venture capital and entrepreneurship. In addition, the drive for European Monetary Union is leading to concerted draconian fiscal restraint. We share these critical views, and the assumption that Europe most probably is heading for recession.

Given the likelihood of further easing by the Bundesbank, the dollar should hold firm. But with German short-term money-market rates already below 4%, this leaves little room on the down side. Over time, we expect additional rate cuts by the Fed in response to disappointing economic news. This should weaken the dollar again in the longer run. But this is not the time for aggressive speculation on a falling dollar.

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